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C O N F I D E N T I A L SECTION 01 OF 03 ANKARA 008846

SIPDIS

STATE FOR E, EB/IFD/OMA AND EUR/SE
TREASURY FOR OASIA - MILLS AND LEICHTER
STATE PASS USTR - NOVELLI AND BIRDSEY

E.O. 12958: DECL: 09/02/2006
TAGS: ECON EFIN PREL TU
SUBJECT: READ-OUT OF IMF VISIT TO TURKEY: FOCUS ON BUDGET

REF: ANKARA 8797

Classified by DCM Robert Deutsch for reason 1.5 (d).

¶1. (C) Summary: On December 4, IMF resident representative briefed EU member countries and us on the December 2-4 visit of IMF Europe Director Deppler. It provided a first impression of the new economic ministers: well-intentioned, and committed to continuing the existing program, but not united on economic policy measures and facing a daunting list of conditions under the program. The IMF plans two staff missions, December and January, before going to the board, probably in February, to release the next tranche of $1.7 billion. The most controversial issue before IMF and GOT is the primary budget surplus, including both measures to meet this year's projected shortfall and next year's target. Also key is the composition of budgetary measures to meet the surplus target (i.e. not just raising taxes, but expenditure reform that addresses chronic deficits in the pension funds). The primary surplus is the one key element of debt sustainability that is completely in the GOT's control, and thus will be an important signal to the markets. We recommend supporting a firm IMF approach to this issue. End Summary.

IMF First Impressions

¶2. (C) IMF resrep began with some general impressions: the new economic ministers are well-intentioned and haven't painted themselves into a corner by committing to bad policies. However, there appears to be some fragmentation. Deputy PM Sener has the role of overall economic policy coordinator, and State Minister Babacan has the role of coordinating with the IMF and World Bank.

¶3. (C) In addition, IMF resrep said the ministers have yet to decide on economic policy specifics. Their policy statements to date (election platform, government program) are very general. The differences became clear on the key issue of the year 2003 primary budget surplus: Deputy PM Sener told the IMF visitors the 6.5 percent target would be fine (and publicly said this target was "reasonable"); while State Minister Babacan in a later meeting stepped back, saying he needed to see budget realizations this year before committing to next year's target.

¶4. (U) IMF Europe 1 Director Michael Deppler and Turkey Mission Chief Juha Kahkonnen met with PM Gul, Deputy PMs Sener and Sahin, Finance Minister Unakitan, and State Ministers Babacan (Treasury) and Tuzmen (Trade), as well as with senior officials in the Treasury, Central Bank and Banking Regulation and Supervision Agency (BRSA).

IMF Schedule and Mission Timing

¶5. (SBU) The new government plans to continue the existing program, and will seek to finish the Fourth Review, per IMF resrep. But the new ministers are facing a long list of outstanding Fourth Review. Furthermore, they need time to formulate a detailed program for 2003, including the full year 2003 budget to be presented to parliament in January. Thus the IMF plans to proceed as follows:

-- December 9-20: full mission to examine conditions for the Fourth Review, and begin working on the 2003 letter of intent.

-- January 2003: follow-up mission to finalize the Fourth

Review and the 2003 letter of intent.

-- February 2003: IMF Board meeting on the Fourth Review, release of $1.7 billion tranche.

¶6. (SBU) IMF resrep stressed that the GOT doesn't need the Fourth Review tranche at the moment. The Treasury is taking advantage of favorable market sentiment to overborrow in the domestic market. (Note: the Treasury has also borrowed $1.15 billion in the Eurobond market since the November 3 elections.)

Fourth Review Conditions -
Structural Reform Issues Loom Large

¶7. (U) IMF resrep proceeded with a status report on outstanding program conditions.
¶8. (SBU) Fiscal Policy: The IMF Mission next week will assess the size of the shortfall towards meeting the 6.5 percent primary surplus target, but the October Mission had calculated it to be as large as 1 percent of GNP, about $1.6 billion. (Comment: MinFin sources also tell us about one percent of GNP shortfall.) IMF resrep speculated that the shortfall could have grown given some post-election spending measures. Very little has been done to address this shortfall to date, except that payments under public works contracts have been frozen (the prior government signed many such contracts in its last days).

-- IMF resrep noted that the primary surplus performance criterion in the program is a key condition; however, "a key objective of the primary surplus is to maintain debt sustainability, and the debt situation is currently good. They have built a financial buffer through over-borrowing."

-- Asked about the tax amnesty issue, Resrep noted there were two separate measures: First, the "Financial Year Zero" law, first passed in 1998 and scheduled to be implemented in January 2003, which the GOT plans to annul; Second, the proposed tax amnesty would establish a cut-off date for overdue tax files - those more than one year old would not be pursued. IMF wouldn't fight these measures, per IMF resrep, but has told the GOT that these measures make it more difficult to increase the tax base and tax revenue, and thus meet the new GOT's social spending goals. (Comment: The "Financial Year Zero" law intends to shift the burden of proof from the GOT to the taxpayer in tax audits: after a short grace period following the implementation date, taxpayers who have not declared their income are subject to audits and possibly penalties. It is intended to establish an incentive to file taxes.)

¶9. (SBU) Monetary Policy: Though the Central Bank is reaching its ceiling under the base money performance criterion (the nominal anchor of monetary policy), both inflation and inflationary expectations are on track. November inflation shows annualized CPI to be 31.8 percent, under the 35 percent target. (Comment: The under target CPI has been achieved partly through delays in raising state-controlled prices of consumer goods, thus building up some inflationary pressure. The GOT needs to raise prices of goods it controls in December, to keep inflationary expectations trending downwards.)

¶10. (SBU) Structural Reforms: IMF resrep stressed that the new government faced a lot of decisions.

-- Public Sector Reform: First, the Government must submit a direct tax reform bill along the lines agreed to with the prior GOT. (Comment: this law would seek to lower overall tax rates by eliminating a lot of special exemptions and pork, thus very politically sensitive.) Second, the GOT needs to show progress on eliminating redundancies in the state economic enterprises (SEEs): the end October condition was 30,000 and latest numbers show 21,000. (Comment: Also politically sensitive, but key to slimming down the state sector and making permanent improvements to the budget.)

-- Privatization: The new GOT has stressed privatization is a top priority, but they have to translate this into a detailed program, per Resrep. The two major outstanding issues are preparing state alcohol and tobacco giant TEKEL and Turk Telekom for privatization. Political level decisions are needed on both: for TEKEL, the issues are reducing overstaffing, cutting tobacco support prices, paying

tax arrears. For Turk Telekom the issue is passing a new law that allows parts of the newly created holding company structure to be sold off.

-- Banking Sector Reform: While there has been good progress on some issues (in December, BRSA plans to tender $250 million of assets assumed from bankrupt banks), the major outstanding condition is resolving Pamukbank, and the Cukurova Holding's shares of Yapi Kredi Bank. IMF resrep said, "The issue is in the courts, but we urged the GOT to give public support to the BRSA so the judges and public understand the GOT position." He added that it would be "difficult" to complete the Fourth Review without resolution of this condition. Otherwise, it would look like the IMF is providing $1.7 billion to bail out these two banks' owner.

Outlook for Next Year's Program

¶11. (U) Resrep said the new government stressed the importance of taking ownership of the program to be developed for 2003, and IMF agreed. The IMF was open to discussing changes in the program, provided there were three key elements: a "prudent budget - we still think 6.5 percent primary surplus is a reasonable target;" BRSA independence - meaning BRSA has the ability to intervene with problem banks and resolve them on a best practices basis without political interference; Disinflation, including setting an ambitious yet realistic inflation target, i.e., 20 percent CPI increase, and preserving Central Bank independence.

¶12. (U) On next year's macro targets, Resrep was firm on the 20 percent CPI target, but stated the 5 percent GNP growth target could be changed by the GOT. On the 6.5 percent primary budget surplus, he noted that given a 5-6 percent growth target, this level of primary surplus represented no fiscal tightening over 2002. In fact, he continued, in real terms discretionary social spending has increased by 12 percent over the last two years.

Comment

¶13. (U) We need to keep a close eye on the banking reform issues. Beyond that, the main debate ahead for the IMF and GOT lies over the primary surplus, both in meeting this year's shortfall and in establishing next year's target. Out of the three main ingredients in debt sustainability - real interest rates, growth and primary budget surplus - only the third lies completely in the GOT control and is thus the most stable element. The GOT cannot count on the current market sentiment continuing throughout 2003.

¶14. (U) The 6.5 percent target may not be sacrosanct, but a major change (as in one percent of GNP or $1.6 billion) would mean the Turks will forgo the chance to pay down their debt in 2003, and thus improve their debt dynamics in a more sustainable way. It could also raise significant market concerns. In addition, the composition of budget measures taken to meet the 6.5 percent is also important and directly related to structural changes such as pension reform (deficits in the GOT pension funds equal 3 percent of GNP, reftel). In short, we should not be neutral in the IMF - GOT discussions on the budget, and we should support the need for a strong surplus, and one that maintains a high level of social spending by strengthening public sector reforms.
PEARSON